# DOW THEORY LETTERS INC.

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40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission


December 2, 1966 Letter 342

THE MARKET: In past Letters I wrote that we would watch 5 major price indicators in our efforts to gauge the direction and power of the primary trend. These are (1) D-J Industrials, (2) D-J Rails, (3) D-J Utilities, (4) D-J 40-Bond Average, (5) Barron's Low-Priced Stock Index. As a rule, "the highest grade investment money" goes into the Utility and Bond Averages, and in Letters 314 and 326 I showed where declining trends in the Utility and Bond Averages have always been bearish for the general market.

The rally which began from the October lows has now lasted over 7 weeks. During this secondary (upward) correction of the primary bear trend, Industrials retraced 30% of their February to October losses, Rails about 29% of their own losses. Much excitment was generated by the rally in Utilities and Bonds, together with the widely-announced thesis that "interest rates have seen their peaks." The rally in the Utility Average was impressive. But in early November the Utility Average began "rolling over," and it remains to be seen whether the Utility Index will prove the bullish indicator it is supposed to be.

The 40-Bond Average entered a short-lived rally. Then, on November 25, unnoticed by almost everyone, the 40-Bond Average broke to a new bear market low at 80.10. The break was below the 1960 low of 80.88, and a potential "double bottom" in the bond Average (i.e. the lows of 1960 and 1966) now no longer exists. At present the 40-Bonds are at their lowest level in 33 years--at their lowest point since 1933. The current yield on the 40-Bonds is a whopping 5.84%. I consider this fresh new low by one of our five "major price indicators" to be bearish. If this were a true primary bull market, the last thing I would expect to see would be a new low in bonds 7 weeks after the stock market rally began. I see the new low in the 40-Bonds as a distinct warning for the bulls. The bear is beginning to stir again. He has pushed one ugly paw out of his lair. It should not be long before he emerges from his hiding place of the past two months--in full view for all to see.

Those who delight in the bearish view now have plenty to talk about, a slide in auto sales, huge auto inventories, weakening in the used car market, a housing slump, a probable tax rise, a drop in new orders for durable goods, slower color TV sales, etc. But let me state this here and now. I am not interested in bearish statistics as "props" for my own bearish stance. After all, aren't all these unhappy business statistics just what the market foresaw when it dropped 251 points in 1966? I want to stress this point:

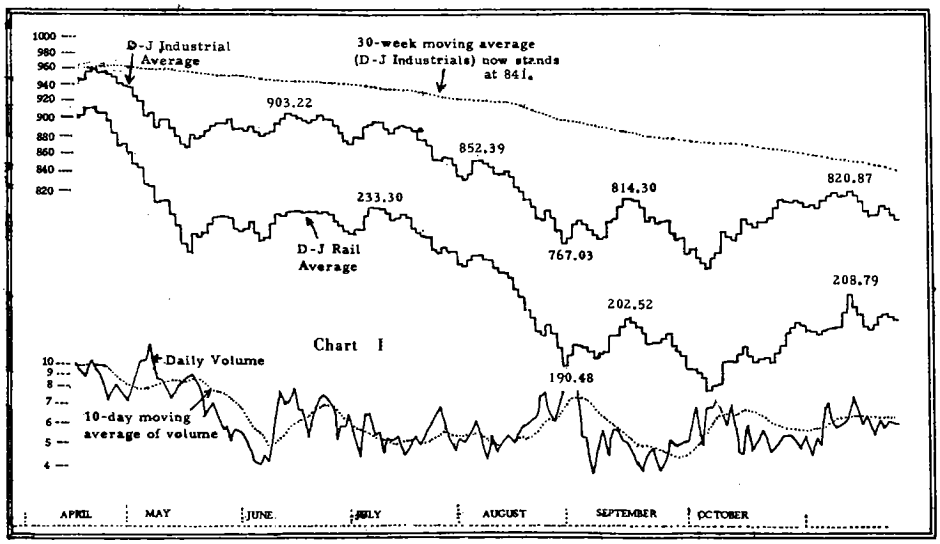
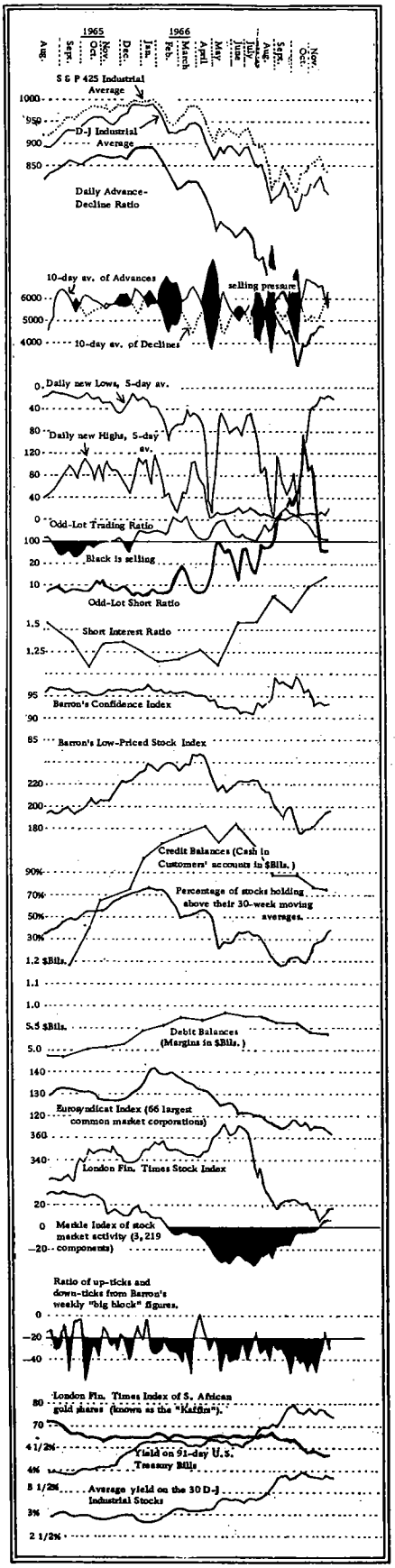


Chart I

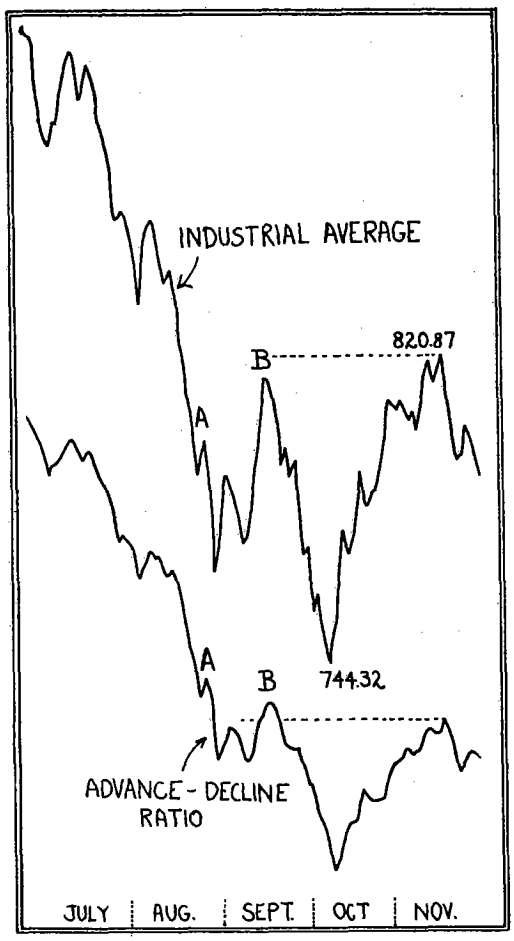

1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

 the main thing I am interested in is the technical condition or the current health of this market.

For what we really want to know is whether the market already discounted the bad news when it fell to 744.32 in October--OR, whether the market is going to head still lower, thereby discounting another round of deepening bad news. My belief is that we are still in the second phase of the bear market, that the long-term technical underpinnings of the market are still bearish, and that new lows will be seen between now and the first few months of 1967. I base this (see last Letter) on the short duration (i.e. 9 months) of the bear market so far, on this week's new low in General Motors, on the new low in the 40-Bonds, on the weakness in the A-D ratio, on the continuing public optimism regarding stocks and the economy as evidenced by almost everything I read and hear, on the current high trading volume, on the long-term bullishness of the odd-lots, and on the violent (bear market) character of the rally since October.

Our policy will remain one of cautious waiting in a highly defensive position (91-day Treasury bills). We will let the bear take his good time about developing; we will let the amateurs and optimists try to "beat" this market with in-and-out scalping operations. As long as the primary trend is down, the buyers and shareholders will be banking their all on a continuance of a secondary correction within a major bear market. They will be "struggling upward in a pool of quicksand," and as soon as they cease struggling they will sink into oblivion, smothered and crushed again by the power of the primary bear trend.

A-D RATIO: It is incredible the way certain fundamental and technical "fashions" can rule Wall Street. For instance, at times "everybody" will be talking about price-earnings ratios, a month later they will be fascinated with the Utility Average, a few months later it will be new highs and lows. Personally, I try to avoid the "fashion of the month." Too often I have found that the indicator which everyone is talking about has ceased to be reliable. It is almost as if the market discounts or ignores the indicator currently in vogue. And this is as it should be. For it is not given to many people to be right about Wall Street. Obviously, if a widely followed indicator acts correctly, a great many people will have been right.




I note that very few people are now studying the relationship between the Industrial Average and the advance-decline ratio. Yet, this is one of the technical phenomena which I have always had faith in (although this indicator too, is by no means infallible). Normally, the A-D ratio and the Industrial Average tend to (1) agree in direction, and (2) confirm each other in the penetration of successive significant points. When these two indicators get "out of gear," such divergence is usually meaningful. It is meaningful, as I see it, for the following reasons. The 30 D-J Industrial stocks represent 40% of the value of the listed shares on the N.Y.S.E. They represent a very high-grade or quality portion of total N.Y.S.E. value. The rest of the stocks obviously represent the other 60% of the value of the N.Y.S.E., but on average they represent a lesser quality group than the 30 Dow stocks.

It is usually significant when the Dow stocks diverge (in direction) from the trend of the A-D ratio. It is also significant when the Dow and the A-D ratio fail to confirm each other in the penetration of corresponding points. The rationale is this: the business of the nation cannot be expected to improve if the great mass (numerically) of corporations cannot do as well as the 30 blue-chip Dow companies.

By the same token, if the 30 Dow stocks cannot improve their outlook along with the mass of N.Y.S.E. corporations, then something is amiss. The same logic applies (bullishly) on the downside. In other words, if the corporations representing 60% of the N.Y.S.E. value do not confirm a new low on the Dow, then it is probable that some sort of a turn for the better is in the wind.

Now, going to the present, note on the accompanying chart that during the September rally the A-D ratio failed to better the little August peak at "A". Both indices then sank to new lows (October), followed by the October-November rally. At the November rally highs I thought it significant that the A-D ratio failed to confirm the penetration of the Dow above the September peak ("B"). Following this non-confirmation, both indicators turned sharply lower. It will be most interesting to see whether any new rally will result in an Industrials bettering of 820.87 (November high) confirmed by an A-D ratio closing above the September peak at "B". Persistent failure by the A-D ratio to better the September high will stall this market or bring in weakness, regardless of any strength in the Industrial Average.

FUNDAMENTALS: The 20 years since World War II have witnessed an almost uninterrupted explosion in U.S. credit. This massive Government-sponsored credit expansion has changed the face of American business methods and thinking, it has bred steady inflation, it has resulted in a "built-in" consumer euphoria. But as the U.S. balance-of-payments worsened during the 1960's and as the giant U.S. gold hoard dwindled, it became necessary to put the brakes on the credit boom.

In the face of the tight money and the credit contraction of 1966, it is well to note that a fantastic amount of financing is now (and will be) necessary. Cities, Municipalities, states, people (personal finance) as well as business itself, are now fighting for their share of dollars.

And worst of all, the crush for credit has arrived at a time when Uncle Sam is engaged in a full-scale war and when all segments of the nation are heavily in debt.

I am grateful to my friend Irving Weiss (Capital Advisors, Inc., 50 Broad St., N. Y.C.) for the accompanying table. I believe it shows very dramatically what has been occurring to corporations over the past 20 years. Note that Weiss wants to make comparisons. To do this he has reduced all 1946-1949 figures to a base figure of $1.00. For example, it can be seen that $1.00 of earnings for General Motors in 1946-49 grew to $5.78 of earnings in 1965, the best profit record of any company. At the same time, $1.00 of earnings for Swift during 1946-49 actually shrank in 1965 to 63¢, the worst record of any.

But the important factor in this chart is what happened to net cash reserves during the past few years. I would like subscribers to take some time with this chart, study it, try to understand it thoroughly. Note that in almost all cases net cash reserves have declined in the 8 years since 1958 (net cash reserves means current cash resources minus current liabilities). In fact, the S.E.C. reported (at mid-year) that all American business corporations (not including financial organizations) did not have enough cash to meet their current bills. They lacked about $170 billion.

Now here is my guess as to what could happen in the period ahead. As the bear market deepens I believe there will be a wild scramble for cash. Corporations will seek to cut overhead, raise cash for expenses, slash expansion programs. At the same time the Governments, states and cities will intensify the fight for cash as they come into the market for their own share, and this new and intensified battle for dollars will drive interest rates back towards the 1966 highs.

| | Annual ***Postwar Credit Expansion (in nearest Bill. of $) | | Annual Corporate Profits | |
|---|---|---|---|---|
| Average of | | Index | | Index |
| 4 years 1946-1949 | 19 | $1.00 | 19 | $1.00 |
| 5 years 1950-1954 | 28 | 1.47 | 22 | 1.15 |
| 5 " 1955-1959 | 38 | 2.00 | 26 | 1.37 |
| 5 " 1960-1965 | 57 | 3.00 | 32 | 1.68 |
| 1 year 1965 | 87 | 4.58 | 45 | 2.37 |
| 1 " 1966 (est.) | 83 | 4.37 | 49 | 2.58 |

| | Average Dollar of Income Annually Using 1946-49 as $1. | | | | *Net Cash Reserves | |
|---|---|---|---|---|---|---|
| | '50-54 | '55-59 | '60-64 | 1965 | 1958 | 1965 |
| Allied Chem. | $1.35 | $1.61 | $2.01 | $2.02 | - 1 | -121 |
| Alcoa | 1.56 | 2.97 | 2.37 | 2.54 | - 14 | -176 |
| American Can | 1.99 | 2.01 | 2.22 | 3.15 | - 61 | - 81 |
| A. T. & T. | 2.09 | 2.90 | 7.00 | 8.65 | -507 | -1,537 |
| Amer. Tobacco | 1.00 | 1.36 | 1.79 | 2.51 | -122 | -166 |
| Anaconda | 1.32 | 1.70 | 1.28 | 2.20 | - 10 | + 20 |
| Beth. Steel | 1.64 | 1.99 | 1.63 | 2.12 | + 59 | -121 |
| Chrysler | 1.18 | .50 | 1.25 | 2.95 | - 80 | -578 |
| du Pont | 1.88 | 2.80 | 3.11 | 2.83 | +175 | + 126 |
| Eastman Kodak | 1.23 | 2.23 | 3.23 | 5.44 | + 72 | + 66 |
| Gen. Electric | 1.72 | 2.46 | 2.48 | 3.66 | -198 | -924 |
| General Foods | 1.13 | 2.28 | 2.79 | 3.37 | - 14 | -128 |
| Gen. Motors | 1.70 | 2.39 | 3.99 | 5.78 | +139 | -208 |
| Goodyear | 1.56 | 2.10 | 3.01 | 4.58 | - 58 | -317 |
| Int. Harvester | 1.23 | 1.97 | 2.14 | 2.85 | + 9 | -299 |
| Int. Nickel | 1.72 | 2.36 | 3.00 | 4.29 | + 42 | + 166 |
| Int. Paper | 1.27 | 1.61 | 1.41 | 1.75 | - 1 | - 74 |
| Johns Manville | 1.89 | 2.15 | 2.19 | 3.00 | + 3 | - 25 |
| Owens Ill. Glass | 1.41 | 2.61 | 2.64 | 3.97 | + 40 | - 41 |
| Procter & Gamble | 1.73 | 1.83 | 3.00 | 3.60 | - 2 | + 138 |
| Sears Roebuck | 1.15 | 1.50 | 1.98 | 3.87 | -200 | 2,096 |
| Stand. of Calif. | 1.52 | 2.18 | 2.55 | 3.21 | - 67 | -488 |
| Stand. of N.J. | 2.00 | 2.60 | 3.08 | 3.90 | -234 | 1,099 |
| Swift | .80 | .61 | .67 | .63 | - 88 | - 80 |
| Texaco | 1.56 | 2.62 | 4.67 | 5.35 | - 9 | -342 |
| Union Carbide | 1.27 | 1.74 | 2.00 | 2.69 | - 50 | + 2 |
| United Aircraft | 2.13 | 4.23 | 2.13 | 5.44 | -142 | -333 |
| U. S. Steel** | 1.51 | 2.58 | 1.72 | 2.15 | -219 | - 96 |
| Westinghouse El. | 1.51 | 2.58 | 2.48 | 4.38 | +112 | -208 |
| Woolworth | .72 | .83 | 1.04 | 1.79 | + 1 | - 67 |

*Net cash reserves means current cash resources less current liabilities

**U. S. Steel maintains substantial cash reserves set aside for construction, etc.

***Expansion obtained from mortgages, commercial bank loans less mortgages, long term corp. debt and trade credit.

See body of report for our estimates of captive credit corporations not included here; including current estimates of 7 cash depleted companies.

Would there be any way out of such a predicament? I do not know, but the one obvious way would be a rise in the price of gold and a boosting of our gold base (this could probably be engineered on a multi-lateral scale, with all nations participating in the gold price rise). At any rate, it is important to see how the current and growing battle for scarce dollars may affect every segment of our economic life. The current "heavily in-debt" position of all Americans and American businesses and the present fight for dollars are probably the two most important factors on the financial front. All news along these lines should be studied carefully, and I will discuss new developments with my subscribers periodically.

QUESTION: A subscriber, Mr. Frank Scicchitano, writes: "I wonder if some comments concerning the odd-lotters is in order. In a bull phase, continued odd-lot selling near the bottom of a reaction generally precedes a new rise. But what of a primary bear trend? It seems to me that if we expect the devastating 2nd phase to unfold, I would expect the public to again pick up the main trend (down) as they once picked up the main trend (up) during the bull market.

"In other words, if we are to see massive liquidation by the funds (which are the public) and other funds, we would also expect to see much odd lot selling through the second and third phase. All the stock that was given to the public (either in 100 share

lots or odd lots) at the tops during '64 and '66, must eventually be given back to the pros.

"So as the public rode the 2nd (bull) phase up, must they also ride the 2nd (bear) phase down? And ultimately selling all they have in disgust during the third (bear) phase."

ANSWER: This is a question which frankly has bothered the devil out of me. We simply do not have adequate statistics for any really extended primary bear market, such as this one is apt to be. Yes, I do think there is great danger of our reading the odd-lots incorrectly from the long-term point of view during this primary bear market.

Daily odd-lot figures were not made available until June, 1939, but we do have monthly statistics going back to 1920, as compiled (privately) by the Brookings institute. A 3-month moving average of the monthly statistics show a general trend towards odd-lot selling from January, 1930 all the way to the major bear market bottom in July, 1932. In other words, odd-lotters (on a long-term basis) did move to the sell side during the major portion of the whole 1929-32 bear market.

Conversely, the 2nd phase of the 1949-66 bull market lasted from 1953 to 1957. But the long-term trend of odd-lots was towards the buy side from late-1954 to late-1956. In other words, the odd-lots did get with the primary trend during much of 1929-32 and during much of 1953-57. But this did not spell the immediate end of the primary movement. By the same token, I wonder if a long-term trend (assuming it is now starting) towards odd-lot selling will spell the immediate termination of the 2nd phase of this bear market? I wish I had the final answer, but I don't. I will say this however, I think that there is a good change that we will see this market go down through its second bear phase even while odd-lotters are selling. There may come a time during this bear market (as happened on a number of occasions during the 1949-66 bull market) when everyone, including the odd-lot public, is acting in harmony with the prevailing primary trend.

NOTES & QUOTES: The U.S. balance-of-payments worsened during the third quarter but the extent of the worsening has been "hushed." The Treasury placed the third quarter deficit at $217 seasonally adjusted. However, a $215 million non-recurring advance (debt) payment by France and Italy and a $30 million "swap agreement" with Canada served to "reduce" the deficit. Without these adjustments, the third quarter deficit would have been $462 million or a rate of $1.8 billion per year, and Treasury spokesmen admit that the deficit is worse in the fourth quarter.

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In his latest report, Alden R. Wells notes that "...gold is an excellent servant but a hard master. Now that it is master, the world deflates by its order and political events in Germany, England and the U.S. respond to its command.

Wells continues, "In Germany a chancellor, given an overwhelming mandate, within months was removed from office because his budget included large sums aimed at helping our balance of payments deficit. General de Gaulle's friends replaced him. In this country, neo-Keynesians told the President that we could have both guns and butter. When he discovered this was not true, he tried to hide the fact and created the famed 'credibility gap' that cost him an election. The home of Keynes is most exposed.

"Quite apparently, there is a universal belief that gold is cheaper than pounds, and pounds will be swapped for several other currencies when gold cannot be obtained. Mr. Wilson has obeyed his gold master until the cost has become dangerously high. Three months after winning an electoral victory as impressive as Johnson's in 1964, conversion of pounds into other monetary units forced a 180-degree change of policy. Two months after this change, his personal popularity sank to a new low. Two months later the shocking defeats of Erhard and Johnson foretold Wilson's future under his new master - gold."

* * * *

Yes, Keyne's home, England, is indeed exposed. Ordered to "deflate" by his creditors, Wilson has pushed Britain into a whopping recession. The British All Industry Production Index fell 4 points to 131 in September, the biggest drop in 9 years. British auto production has dropped better than 25% below last year. On November 24 it was announced that British unemployment has advanced to its highest level in 3½ years. Pressed against the wall and with his political future at stake, Prime Minister Wilson has announced that he will not ease up on the austerity program.

In a full-length article, Business Week (Nov. 19) discusses "The Economic Battle of Britain." States the magazine, "If the economic underpinnings of the British pound come apart, the least that could happen is a world money crisis. The worst is a collapse that would wrench apart the trade of the industrialized nations, stifle the limited program of the developed lands, and poison relations among the countries of the free world." Perhaps the only long-term hope of Britain is to join the Common Market. But here Britain is subject to the veto of de Gaulle. Best bet is that France (long of gold) will request a Britiah devaluation as a condition of entry to the Common Market. French Foreign Minister de Murville has been telling journalists that Britain must drop its east of Suez commitments and that the pound must be eliminated as a reserve currency. If so, the dollar would then bear the full brunt of being the free world's only reserve currency. This, more than ever, would call for a multi-lateral revaluation of gold.

* * * *

Meanwhile, the Federal Reserve Board Gold Reserve Ratio has dropped to a new low of 32.5%. It seems only a matter of months (see Letter 238) before the ratio sinks into the "danger zone" (below 30%). The gold backing was removed from Federal Deposits in early 1965, and now applies only against Currency. With the statutory level of 25% probably being approached in 1967, Congress and the President will be faced with an unprecedented emergency--and the decision as to whether to put the U.S. on a "full paper currency" with no gold backing whatever.

STOCKS: I have been stressing the action of the "giants" or the "economy movers" in recent Letters, with particular emphasis on General Motors. With this Letter I include charts of 5 chemical giants. These are not specialty chemical companies, they are huge enterprises with sales so wide and diversified that they are linked to the economy in every way. The picture is the same with all these chemical stocks. In each case, the stock has topped out, and in each case the stock is obviously discounting trouble with sales, earnings or both in the period ahead. Hardly a sign of health for the 1967 business picture. (Charts courtesy of Quote Digest, 110 N. Lorraine, Witchita, Kansas).